

Sustainable Finance

Karen Wendt

# EU Action Plan for Sustainable Growth


New Impacts and Opportunities  
for Asset Managers

 Springer

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# Sustainable Finance

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## Authors Preamble

One can see from space how the human race has changed the Earth. Nearly all of the available land has been cleared of forest and is now used for agriculture or urban development. The polar icecaps are shrinking and the desert areas are increasing. At night, the Earth is no longer dark, but large areas are lit up. All of this is evidence that human exploitation of the planet is reaching a critical limit. But human demands and expectations are ever-increasing. We cannot continue to pollute the atmosphere, poison the ocean and exhaust the land. There isn't any more available. (Stephen Hawking, Physicist & Author)

Over the past several years, the relevance of sustainability, ESG criteria, and impact investing has grown not only at the corporate and national level but also on a global scale. Specifically, impact investing and positive selection methodologies have recently sparked increasing research and practical attention. Up to now however there has been no standard definition of sustainability and sustainable finance, and what it exactly means and the concepts of ESG and impact investing have remained fuzzy. Through the intervention of the EU Commissions that provide a new definition of sustainability the entire field is now newly generated and aligned around the EU Action Plan for Sustainable Growth, and there is clarity now about what sustainability means and what not. As humanity, we will have to learn to adapt to the carrying capacity of a world with limited resources. We are at the start of an unparalleled global shift toward more holistic sustainability: economically, socially, and ecologically. Multiple systems, such as the transportation system, the healthcare system, the educational system, the energy system, the food system, and the financial system, will all need to be rethought. One significant leverage point to alter the financial system is the EU-Taxonomy for Sustainable Growth. The finance industry has inherited a crucial role in achieving the UN 2030 agenda and the Paris Agreement. In particular, innovations in digital finance have demonstrated their potential to facilitate a shift to more sustainable business models within the finance industry. Nonetheless, further substantial investments of at least \$3 trillion per year are needed in the EU to implement the Paris Agreement and fulfill the EU Sustainable Finance Action Plan (United Nations 2024).<sup>1</sup>

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<sup>1</sup>United Nations 2024: sustainable Development Blog available at <https://www.un.org/sustainabledevelopment/blog/2024/04/press-release-fsdr-2024/>

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# Changing the Game: The EU Is Redirecting Capital Flows to Sustainable Purposes with Its EU Action Plan

1

## From Vision to Execution

The EU Sustainable Finance Action Plan (EUR-LEX 2018) on financing sustainable growth (hereinafter referred to as the Action Plan) is based on the Final Report of the High-Level Expert Group (HLEG) on Sustainable Finance set up by the EU Commission. It contains the final proposals of the expert panel, which was composed of high-level industry experts from the asset management sector and academia. The taxonomy includes a ten-point plan for transforming the economy into a sustainable one. In addition to key HLEG recommendations, it installs the introduction of climate benchmarks, accounting rules, new tasks on credit rating agencies, and the consideration of sustainability in prudential regulations for banks and insurance companies, which includes a “Green Supporting Factor” (EUR-LEX 2018). The Green Supporting Factor means that the EU incentivizes the transformation of the economy toward green production and increased investment volume for green investments (EU High-Level Expert Group on Sustainable Finance 2018 in EUR-LEX 2018). At the heart of this is a unified classification system of economic activities, called taxonomy, which aims to end the fragmentation, fraying, and fragmentation of the notion of sustainable or green investments.

The taxonomy defines a methodology, as well as quantitative and qualitative screening criteria. The taxonomy lists technical criteria and defines the requirements for sustainable companies, investments, projects, and funds. It contains a clear description of which investments, companies, projects, and funds are to be considered sustainable in the sense of the EU sustainability definition. So far, the basic framework of the technical taxonomy is in place, as well as a well-developed Green Bond Standard, which includes the requirements for registration as an “EU Green Bond.” The stakeholder dialogue on the taxonomy, the Green Bond Standard, and the climate benchmarks and climate accounting was completed in 2019 (EUR-LEX 2020). An important part of the package is the governance structure. The agreement provides for an independent platform for sustainable finance

(Platform for Sustainable Finance) to develop and maintain the full taxonomy. The EU has launched the International Platform for Sustainable Finance (IPSF) with third countries and plans to establish the stand-alone organization Sustainable Infrastructure Europe (EU Commission 2019).

The taxonomy is flanked by the Disclosure Regulation, which is to be applied from 2021 (EUROSIF 2021). In light of these changes, the relevant question is which areas of the action plan are already well developed, what is required, and how can the business community and investors, asset managers, and institutional investors with fiduciary duties adapt to this.

The European Union (EU) has already taken significant steps toward sustainable finance through its Action Plan for Financing Sustainable Growth. The Action Plan was developed by the High-Level Expert Group on Sustainable Finance (HLEG), a group of industry experts with the purpose of redirecting capital flows toward sustainable growth, enforcing investments based on sustainability considerations, and addressing environmental and social issues by creating positive economic, environmental, and social impacts and being aware of negative social and environmental impacts that need to be mitigated.

The EU therefore has reinvented sustainable finance by giving it its own definition.

In terms of the EU Commission, sustainable finance starts with a positive investment selection methodology based on a taxonomy invented and recommended by the EU High-Level Expert Group and agreed upon and accepted by the EU organs. Sustainable investment therefore starts with an investment universe that is aligned with the EU Taxonomy. The EU has defined the Green Taxonomy and the Social Taxonomy and promotes long-term economic stability and resilience. The EU definition of sustainability is comprised of three elements: positive selection methodology based on the Green or Social Taxonomy, the environmental and social impact screening to ensure that the assets financed do no significant harm to any of the other sustainability, and taxonomy goals stipulated in the EU Taxonomy and finally using ESG filters like the OECD norms-based screening (see also Chap. 2).

The Action Plan comprised 14 key reforms (EUR-LEX 2018), organized into three main areas:

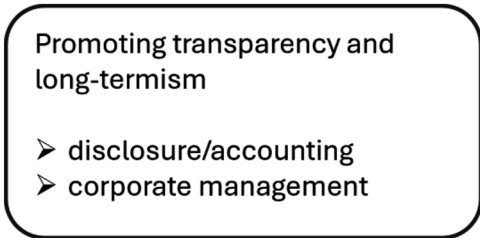
These 14 areas are as follows:

- Diversification: redirecting capital to sustainable purposes (see Fig. 1.1).
- Transparency and sustainability governance (Fig. 1.2).
- Embedding sustainability into risk management (Fig. 1.3).
- Redirecting private capital to sustainable purposes and investments.
- Sustainable activities get classified (taxonomy).
- Environmentally friendly financial products are labeled (e.g., green bonds).
- Sustainability becomes a decision criterion in investment advice and asset management.
- Benchmarks for sustainable activities are regulated.
- Sustainability must be given greater consideration in ratings and market analyses.

**Fig. 1.1** Redirecting capital to sustainable growth: core areas of the EU Action Plan



**Fig. 1.2** Promoting transparency and sustainability through sustainable governance



**Fig. 1.3** Embedding sustainability into risk management



- Institutional investors and asset managers must take sustainability criteria into account in their offerings, advisory, and wealth management activities.
- Institutional investors and asset managers must transparently integrate sustainability considerations based on the EU Action Plan in their investment decisions and investment policies.
- Banks and insurance companies must take climate risks into account in their risk management and capital requirements.
- Regulations on the disclosure of sustainability information are tightened.
- Sustainable corporate governance is promoted; short-term thinking on the capital markets is to be reduced.

In order to achieve these goals, the following core activities are required:

- Integrate sustainability in the ratings of rating agencies.

- Require institutional investors to make sustainability a second decision criterion in their investment policy.
- Asset managers have to take sustainability into account in their decision-making process.
- Banks and insurance companies have to calculate climate value at risk.

The content of these three figures is explained following the description of the 15 reforms for better contextualizing and understanding.

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## The 15 Reforms the EU Is Undertaking

In detail, the 15 key reforms according to the EU Commission (EUR-LEX 2018) are as follows:

1. Sustainable Taxonomy: The EU aimed to create a unified classification system, or “taxonomy,” for sustainable economic activities. The taxonomy would provide businesses, investors, and policymakers with a common language to identify which economic activities are considered environmentally sustainable. It helps prevent greenwashing and guides investments toward projects that contribute to climate and environmental objectives. The taxonomy has three parts: the Green Taxonomy (see Chap. 2), the Brown Taxonomy (see Chap. 2), and the Social Taxonomy (see Chap. 2).
2. Disclosure requirements: Enhancing transparency and disclosure of sustainability-related information was another key aspect of the EU Action Plan. The EU Sustainable Finance Disclosure Regulation (SFDR) which is intertwined with sustainable activities provides a clear framework for reporting of positive and negative impacts of the business activity complemented by the risk management activities undertaken to mitigate those impacts and risks topped up with a clear scrutiny to environmental, social, and governance (ESG) factors by financial institutions and companies. This allows investors to calibrate this information to their decision-making instruments and policies. It helps investors to add the sustainability criteria to the decision-making process and make more holistic and informed decisions and encourages, at the same time, businesses to integrate sustainability considerations into their strategies.
3. Fiduciary duty and investor responsibilities: In the famous lawsuit *Cowan versus Scargill* (1985), for the first time, it was decided by the UK High Court that fiduciary duties can require the institutional investor to take into account sustainability issues. However, this field of fiduciary duties has been very disputed by scholars and practitioners likewise. The EU plans to clarify the fiduciary duties of institutional investors and asset managers and expand them to the field of sustainability. The aim is to ensure that environmental and social factors are considered in their decision-making process, impact, and risk assessments, aligning investments with the long-term interests of their clients.

4. Low-carbon benchmarks: The EU establishes two EU-wide low-carbon benchmarks to guide investors toward low-carbon investment strategies. These benchmarks help steer investments away from carbon-intensive industries and toward climate-friendly projects.
5. Creating EU-certified products like the EU Green Bond through the application of the new Green Bond Standards: The Action Plan develops standards and labels for green bonds to enhance transparency and credibility in the green bond market. This would facilitate investment in projects with positive environmental impacts (Chap. 3).
6. Sustainable finance in risk management: The EU integrates sustainability risks into the risk management processes of financial institutions. By incorporating environmental and social factors into risk assessments, financial institutions make better decisions and better understand and manage their exposure to sustainability-related risks and impacts.
7. Strengthening credit rating agency analysis: The EU Action Plan proposed encourages credit rating agencies to include sustainability risks in their ratings. This provides investors with more accurate and comprehensive information on the creditworthiness of companies, considering their environmental and social performance.
8. Sustainable retail investment products: The EU promotes the availability of sustainable investment products for retail investors. By providing more sustainable options for individual investors, the EU Action Plan sought to increase the accessibility of sustainable finance.
9. Incorporating sustainability in prudential requirements: The EU considers the impact of sustainability factors when designing and implementing prudential rules for financial institutions. This ensures that the financial sector contributes to sustainable development and stability.
10. Capacity building and technical assistance: The EU Action Plan includes measures to support capacity building and technical assistance for sustainable finance across the EU. This helps develop expertise and knowledge within the financial sector, facilitating the transition to a sustainable economy.
11. Reinventing ESG: The EU Commission and the European Securities and Markets Authority (ESMA) do not consider the current ESG ratings as consistent and therefore develop a framework for measuring sustainability.
12. Credit business: The EU Action Plan seeks to amend the credit business, as companies need to provide their sustainability information to get credit, no money without environmental and social governance.
13. Introduction of the EU Green Deal.

The EU Green Deal is a comprehensive and ambitious roadmap proposed by the European Commission to make the European Union a more sustainable, climate-neutral, and environmentally friendly economy by 2050. The Green Deal was introduced in December 2019 as the EU's response to the pressing challenges of climate change, biodiversity loss, and environmental degradation. The primary objective of the EU Green Deal is to transform the EU into the world's first climate-neutral continent by 2050. This means that the EU aims to